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September 15, 2008

AGENDA ITEM 9a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Domestic Equity Manager Annual Review

II. PROGRAM: Global Equity

III. RECOMMENDATION: Renew the contracts for CalPERS' twelve domestic equity managers listed below for a period of one year. Wilshire's opinion letter is shown in Attachment 1. Wilshire's disclosure letter is shown in Attachment 2. The individual manager summaries are shown in Attachment 3.

Active Managers

AllianceBernstein L.P.
The Boston Company
Marvin & Palmer
Pzena Investment Management
Turner Investment Partners

Enhanced Managers

Golden Capital Management
INTECH
T. Rowe Price

Long/Short 130/30 Managers

Analytic Investors
First Quadrant
JP Morgan
Quantitative Management Associates

IV. ANALYSIS:

Executive Summary

This agenda item recommends the approval of the twelve manager contracts and provides an annual review of the external domestic equity manager program. The CalPERS external active domestic equity program consists of five active managers, three enhanced managers, and four long/short 130/30 managers. All managers in this program have one year renewable contracts contingent upon the Investment Committee's approval as recommended in this agenda item. Each contract contains a provision allowing for termination upon 30 days notice.

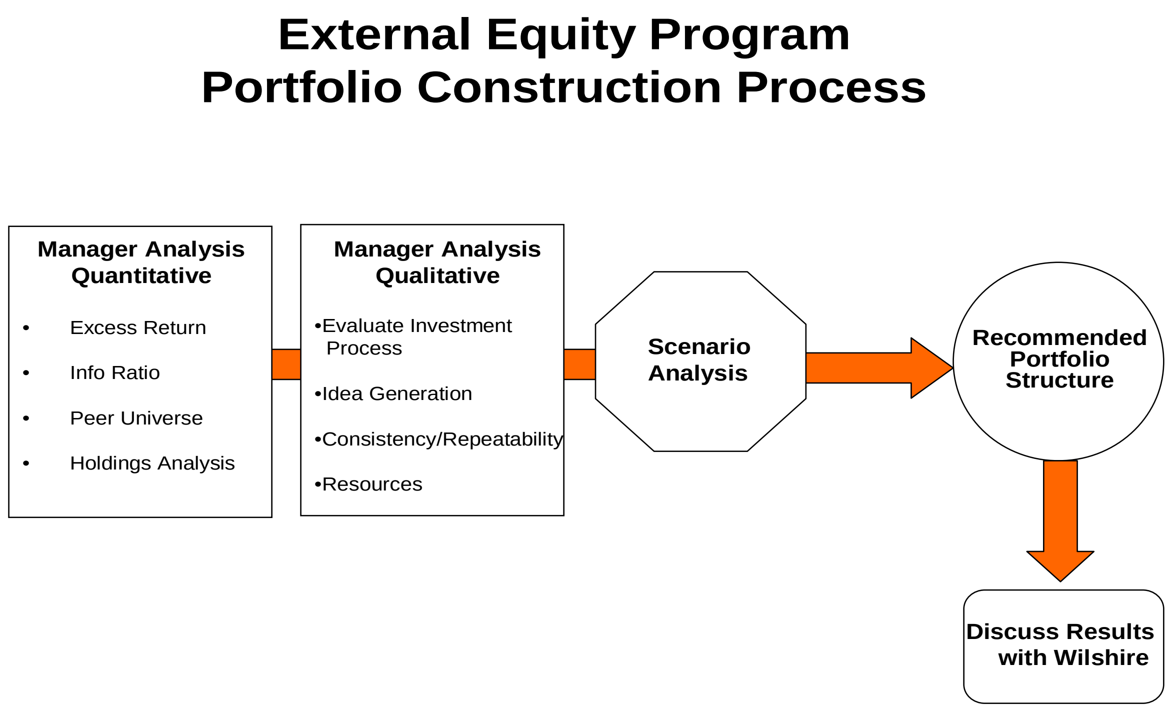
This annual review is presented in four sections: 1) Portfolio Construction Overview, 2) Current Portfolio Structure, 3) Performance Attribution, and 4) Future Enhancements.

Section 1 – Portfolio Construction Overview

The external domestic equity portfolio ("the Portfolio") is managed using a portfolio construction process that entails both quantitative and qualitative analysis when evaluating how each investment manager fits within the Portfolio. The portfolio construction process begins with the thesis that internal equity management is the default investment. Given CalPERS' internal equity capabilities, as demonstrated by the success of a broad array of index and enhanced/active strategies, internal management is considered the best passive alternative**.** This process obliges the Global Equity staff to invest only with those managers expected to outperform the internal equity funds and whose skill sets cannot be easily replicated within CalPERS.

This process was formally implemented during the first quarter of 2008 in an effort to produce a more favorable return-to-risk profile. Staff utilizes this process when making any changes to the Portfolio. Figure 1 diagrams the process.

Figure 1

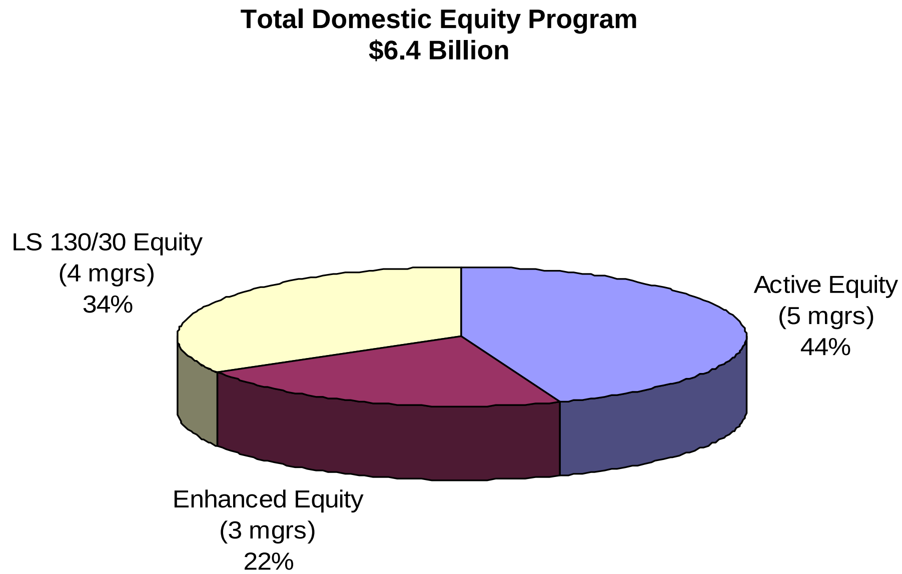


The objective of the portfolio construction process is to identify the optimal trade off between return and volatility by increasing CalPERS' exposure to more active risk strategies that cannot be easily replicated within CalPERS while minimizing redundancy among the investment approaches. By utilizing this new process, staff expects to maximize uncorrelated sources of alpha, resulting in a portfolio that is expected to complement the total Global Equity portfolio with the objective of generating more alpha over multiple time periods. However, there is an expected trade-off with this approach of integrating more active management versus the lower tracking error approaches (i.e. enhanced indexing). The concentration of strategies that employ more active risk comes with higher return expectations but also higher annual volatility.

Section 2 – Current Portfolio Structure

Using the portfolio construction framework just described, the current external domestic equity program is comprised of three strategies: 1) Active, 2) Enhanced, and 3) Long/Short 130/30. Figure 2 illustrates the current allocation among the three strategies within the Portfolio.

Figure 2



As of June 30, 2008, total assets under management for CalPERS' total domestic equity program were approximately $6.4 billion. Figures 3 and 4 show how the assets are allocated among the managers in the three strategies as of June 30, 2008.

Figure 3

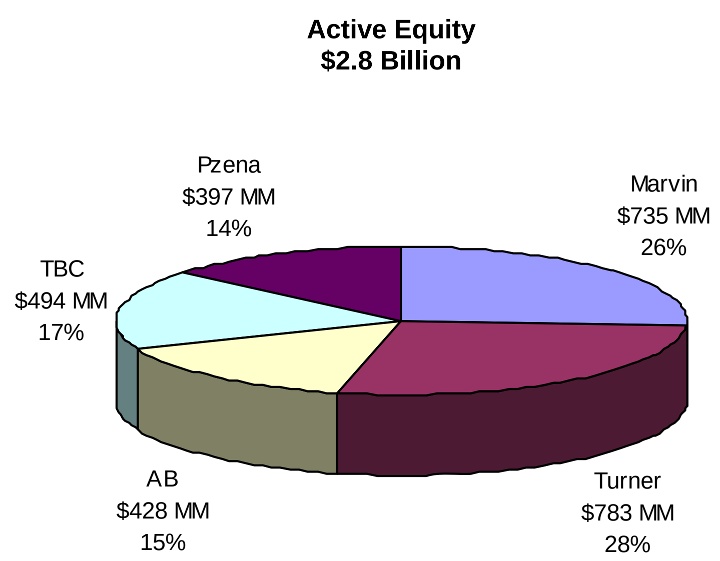
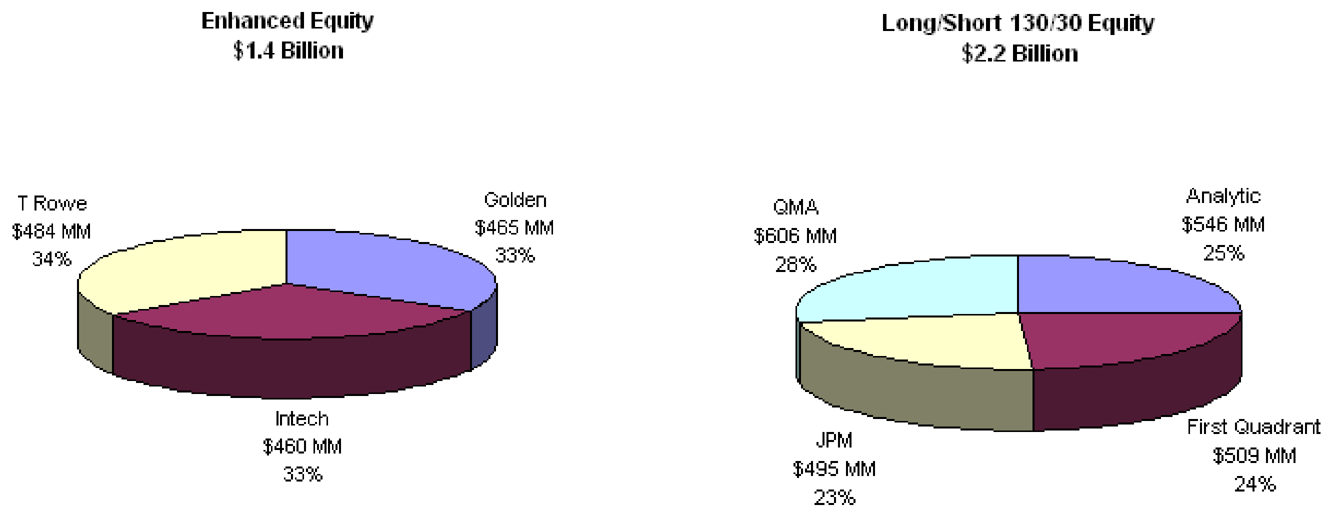


Figure 4



Manager allocations are a function of each manager's expected alpha return pattern, tracking error, excess return correlations, and staff's professional judgment. Managers who exhibit consistent outperformance characteristics will have higher allocations. Managers who exhibit short-term volatility characteristics and whose portfolios are more concentrated have lower allocations. Although these managers may experience more volatility in the short term, their inclusion in the portfolio over the long term enables the Portfolio to capture the expected outperformance when their strategies are in favor.

Section 3 - Performance Attribution

The Portfolio is expected to exceed the composite benchmark by 100 bps, net of fees, over a full market cycle of three to five years. Table 1 illustrates the Portfolio's performance on a cumulative and annualized basis through June 30, 2008. The highlighted column illustrates the performance of each strategy since the new portfolio construction process was implemented on March 1, 2008.

Table 1

External Domestic Equity Manager Programs	Since March 1, 2008 Restructure Return	Fiscal Year 07/08 Return	Ann'lzd 3 Year Return	Ann'lzd 5 Year Return	Ann'lzd Since Inception Return Through June 2008*	Ann'lzd Since Inception Active Risk Through June 2008*	Ann'lzd Since Inception IR Through June 2008*
Active Mgrs	-2.68%	-13.47%	4.70%	8.52%	4.49%	3.06	-0.02
Composite Benchmark	-2.66%	-12.89%	4.89%	9.25%	4.57%		
Active Return	**-0.02%**	**-0.58%**	**-0.19%**	**-0.73%**	**-0.08%**		
Enhanced Mgrs	-2.39%	-15.33%	3.30%	N/A	5.16%	0.97	-0.68
Composite Benchmark	-2.97%	-13.37%	4.37%	N/A	5.82%		
Active Return	**0.58%**	**-1.96%**	**-1.07%**	N/A	**-0.66%**		
Long/Short 130/30 Mgrs	-1.57%	-14.28%	N/A	N/A	-10.67%	2.28	-0.50
Composite Benchmark	-2.74%	-12.63%	N/A	N/A	-9.52%		
Active Return	**1.17%**	**-1.65%**	N/A	N/A	**-1.15%**		
Total Portfolio	-2.20%	-14.54%	3.87%	7.94%	10.44%	2.52	0.05
Composite Benchmark	-2.80%	-13.03%	4.63%	8.43%	10.33%		
Active Return	**0.60%**	**-1.51%**	**-0.76%**	**-0.49%**	**0.11%**		

Source: State Street Bank. Returns are net of fees and CFA compliant.
*Program inception Dates: Active, 5/31/98, Enhanced, 9/30/04, Long/Short 3/31/07.

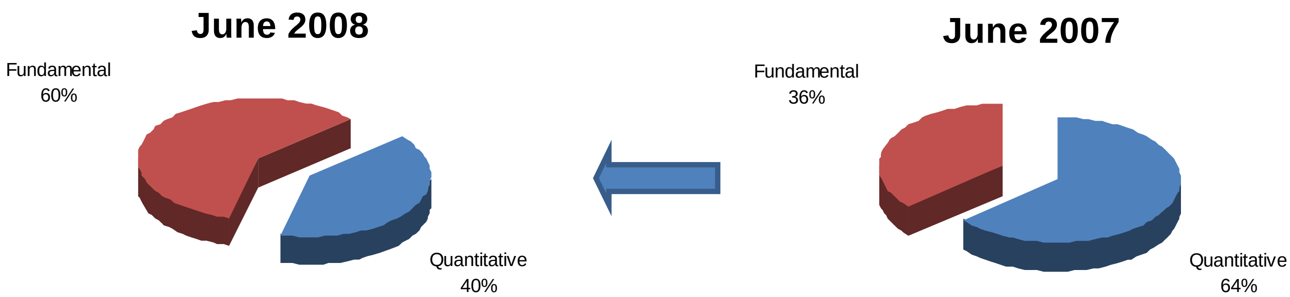
The performance of the Portfolio has lagged the program's custom benchmark by 1.51% for the fiscal year ending June 30, 2008. The majority of the underperformance occurred in the third and fourth quarter of 2007, where the Portfolio had a significant overweight to quantitative managers which underperformed due to the liquidity crisis in the U.S. equity markets that began in August 2007. This is further illustrated in Table 2 below. Staff has subsequently reduced the Portfolio's overweight to these strategies in order to diversify the Portfolio's source of alpha, as shown in Figure 5.

Table 2

External Domestic Equity Manager Programs	Second Quarter 2008	First Quarter 2008	Fourth Quarter 2007	Third Quarter 2007
Active Mgrs	-1.86%	-11.81%	-1.98%	2.01%
Composite Benchmark	-1.98%	-9.57%	-3.38%	1.71%
Active Return	**0.12%**	**-2.24%**	**1.40%**	**0.30%**
Enhanced Mgrs	-1.91%	-9.59%	-4.71%	0.18%
Composite Benchmark	-2.46%	-9.65%	-3.34%	1.70%
Active Return	**0.55%**	**0.06%**	**-1.37%**	**-1.52%**
Long/Short 130/30 Mgrs	0.00%	-10.35%	-3.76%	-0.65%
Composite Benchmark	-2.07%	-9.62%	-3.22%	2.00%
Active Return	**2.07%**	**-0.73%**	**-0.54%**	**-2.65%**
Total Portfolio	-1.22%	-10.70%	-3.67%	0.57%
Composite Benchmark	-2.16%	-9.64%	-3.33%	1.76%
Active Return	**0.94%**	**-1.06%**	**-0.34%**	**-1.19%**

Source: State Street Bank. Returns are net of fees and CFA compliant.

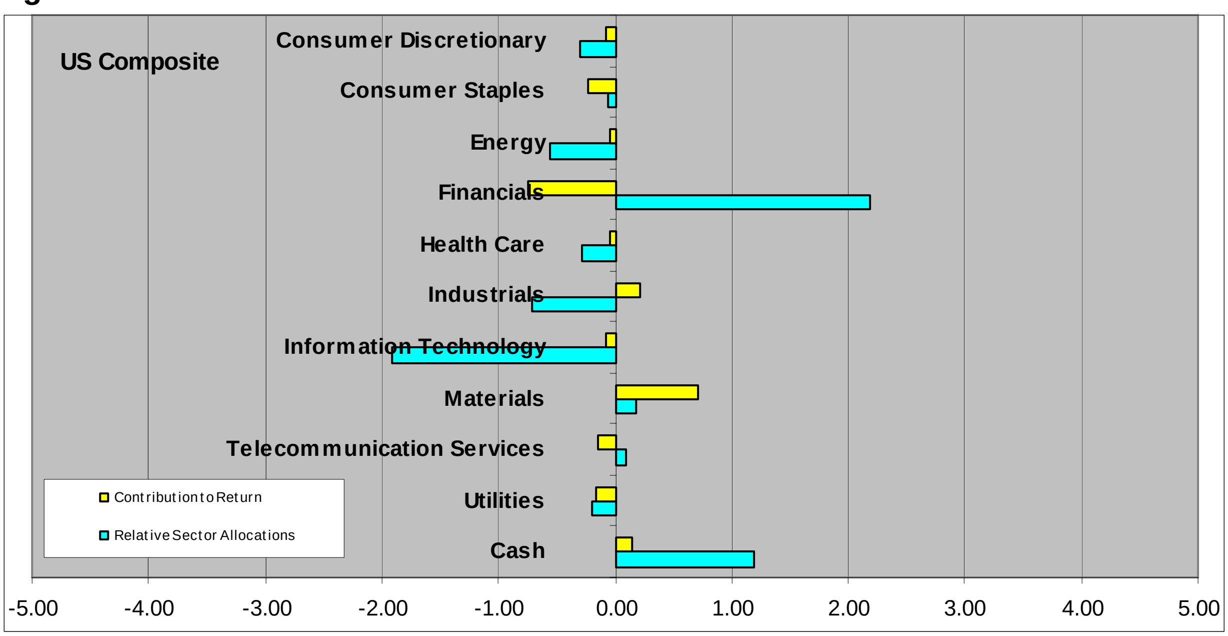
Figure 5



Although staff was limited in its options to augment the portfolio due to the lack of managers with the characteristics staff sought, it made changes in the portfolio structure. First, and most significant, staff initiated a comprehensive evaluation of the external manager program during the first quarter of 2008, which resulted in restructuring the Portfolio. Second, staff funded two additional U.S. Equity Long/Short 130/30 managers through the spring-fed pool process in April 2008. Although the time frame since the restructuring is short, relative performance has improved.

Figure 6 illustrates the portfolio sector allocations relative to the benchmark sector allocations and their contribution to return over the past fiscal year ending June 30, 2008.

Figure 6



There were two significant over/under weights in the Portfolio during the past fiscal year. The Portfolio's largest overweight was to the financials sector by 2.18% which detracted from the performance of the portfolio by 0.75%. The Portfolio's largest underweight was to the information technology sector at 1.92% and it detracted from the performance of the portfolio by 0.08%. Both of these positions were typical of our value managers. Both industrials and materials sectors contributed positively to the portfolio and holdings in these sectors were typical of our growth managers.

Performance by Manager

Table 3 illustrates each manager's performance relative to its respective benchmark since the initial funding date through June 30, 2008.

Table 3

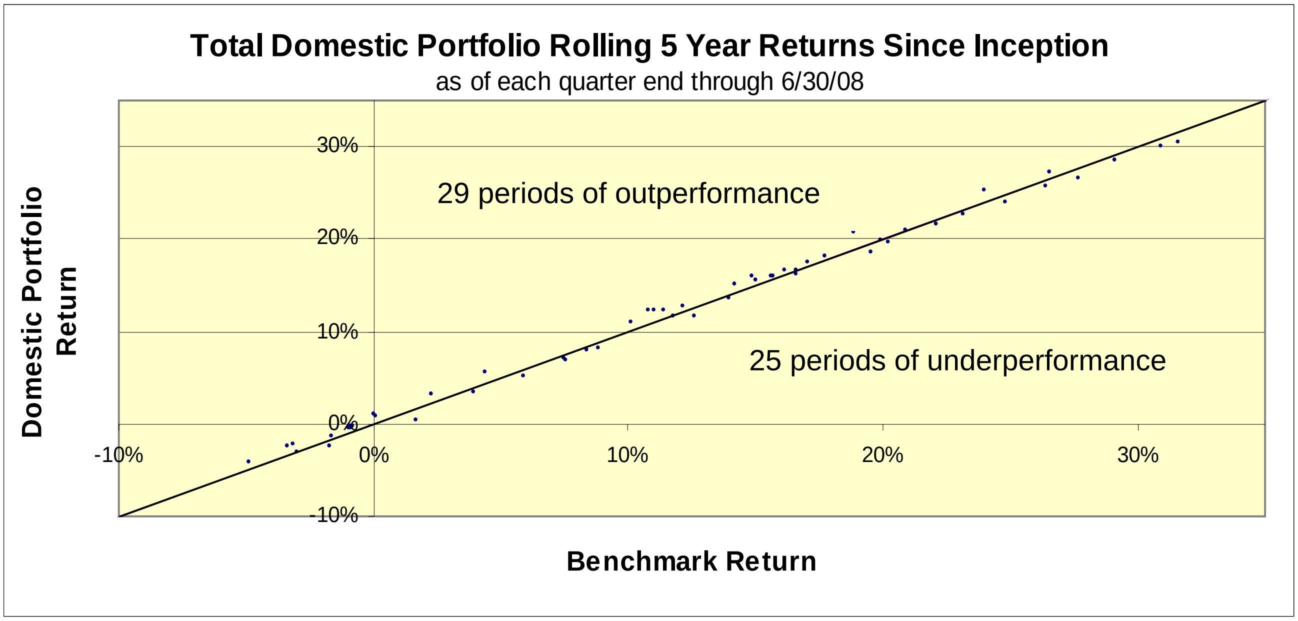
External Domestic Equity Manager	Since March 1, 2008 Restructure Active Return	Fiscal Year 07/08 Active Return	Ann'lzd 3 Year Active Return	Ann'lzd Since Inception Active Return through June 2008	Ann'lzd Since Inception Active Risk Through June 2008*	Ann'lzd Since Inception IR Through June 2008*	Inception Date
Active Managers							
AllianceBernstein L.P.	-2.66%	-3.95%	-1.41%	1.65%	5.79	0.29	Sept 2000
The Boston Company	4.26%	8.20%	6.08%	2.22%	6.49	0.34	June 1998
Marvin & Palmer	5.68%	12.58%	N/A	4.71%	9.99	0.47	Nov 2006
Pzena Investment Management	-7.95%	-14.64%	-6.80%	1.13%	7.29	0.16	Sept 2000
Turner Investments	-1.38%	0.48%	N/A	1.84%	5.75	0.32	Nov 2006
Enhanced							
Golden Capital	0.38%	1.12%	N/A	1.40%	1.23	1.14	Mar 2007
INTECH	-0.15%	0.31%	-0.59%	0.25%	1.54	0.17	Oct 2004
T. Rowe Price	1.60%	1.55%	N/A	1.17%	0.86	1.36	April 2006
Long/Short 130/30							
Analytic Investors	0.83%	-0.49%	N/A	1.33%	3.96	0.51	May 2007
First Quadrant*	4.41%	4.41%	N/A	4.41%	8.38	0.22	April 2008
JP Morgan*	1.20%	1.20%	N/A	1.20%	1.06	1.14	April 2008
QMA	1.03%	-0.57	N/A	-0.57%	6.81	0.24	May 2007

Source: State Street Bank. Returns are net of fees and CFA compliant.
*Inception Date 4/1/08.

Eight of the twelve managers in the portfolio were funded within the past three years, thus the current portfolio has a relatively short performance history. Most of the managers have outperformed since inception, although there are a few managers who have underperformed over more recent time periods. The majority of these managers adheres to style specific investment strategies and takes more active risk within their portfolios. Additional individual manager performance analysis and commentary are shown in Attachment 3.

Chart 1 shows the Total Domestic Equity program's performance relative to its benchmark on a 5-year rolling basis. The points above the diagonal line represent periods of outperformance, while points below the line are periods of underperformance.

Chart 1



Section 4 – Future Enhancements

Although a number of improvements have already been implemented, staff continues to evaluate the Portfolio for inclusion of new ideas. Staff is currently evaluating and researching additional investment opportunities that are expected to improve the Portfolio's performance. Inclusion of future strategies to the Portfolio will adhere to the portfolio construction process earlier mentioned and will employ the following broad themes:

- Reduce exposure to low active risk strategies. Conversely, increase exposure to strategies that take more active risk.
- Reduce the relationships with managers that have shown minimal success in adding positive alpha.
- Optimize allocations to each manager.
- Allocate to managers that are expected to generate a more favorable return-to-risk profile for the total Portfolio.

V. STRATEGIC PLAN:

External investment manager performance is monitored by staff and reported to the Investment Committee per CalPERS Strategic Plan, Goal IV: Assure that sufficient funds are available, first, to pay benefits and, second, to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

The purpose of this item is to keep the Investment Committee informed of the performance of the External Equity Manager Portfolio.

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